CPI Competition Policy Institute

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OFFICE OF SECRETARY

Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M St., N.W. Room 222
Washington, D.C. 20554

Re: CC Docket 96-98 Ex Parte Filing

Dear Mr. Caton:

Attached is an ex parte letter from the Competition Policy Institute to the Federal Communications Commission. Two copies of this letter are being filed with your office today. Please consider these comments as part of the official record in CC Docket No. 96-98. Thank you.

Sincerely,

John Windhausen

John Windhausen
General Counsel

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CPI Competition Policy Institute

July 23, 1996

Chairman Reed E. Hundt
Commissioner James H. Quello
Commissioner Rachelle B. Chong
Commissioner Susan Ness
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C.

In Re: CC Docket 96-98

Dear Chairman Hundt:

The Competition Policy Institute (CPI) supports the pro-consumer and pro-competitive thrust of the Commission's Notice in CC Docket 96-98. We supported nearly all of the Commission's tentative conclusions in our comments on the Notice. CPI's basic analysis is that the consumer interest is best served by a national policy framework that leads to the rapid introduction of local exchange competition.

In recent weeks, there has been much discussion about the links between interconnection pricing and access charges. We understand the Commission is now considering a "transition" to connect its decision on interconnection pricing with its planned proceeding on access charge reform. During this transition, incumbent local exchange companies would presumably continue to collect some portion of access charges from carriers that use unbundled network elements to complete long distance calls in conjunction with the provision of local exchange service. These access charges would be imposed even though the purchaser is paying the full cost of the unbundled network elements.

There are several reasons why we disagree with this approach. First, we have serious concerns that the imposition of access charges on local competitors (added to prices of network elements) will distort the incentives for new entrants and delay the emergence of local exchange competition. Second, the imposition of access charges in this case is inconsistent with the provisions of the 1996 Act that require unbundled network elements to be priced at cost.

Finally, <u>as long as a Bell Operating Company collects such non-cost-based access charges, that BOC cannot meet the competitive checklist</u> in §271 of the 1996 Act and cannot receive authority to enter the interLATA market. The 1996 Act, in Section 271(c)(2)(B)(ii), requires that access to network elements be provided in accordance with the requirements of

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Section 252(d)(1), which requires that rates be based on cost. The addition of non-cost-based transition access charges onto cost-based interconnection charges means that a Bell Operating Company will not meet the second item of the competitive checklist. In this case, the Commission must weigh the effect of delaying BOC applications for entry into long distance when evaluating the merits of imposing access charges on top of cost-based prices for unbundled network elements.

Some argue that a transition charge is needed to support universal service while the Commission completes its work in the universal service rulemaking. If the Commission decides to adopt such an interim charge in this docket, it should be limited to those elements of the current access charge regime that can be directly related to support for universal service, such as the Universal Service Fund, Lifeline, Link Up and Long Term Support amounts. In contrast, such charges as the Carrier Common Line Charge and the Transport Interconnection Charge (which are not directly related to universal service) should be excluded from any interim universal service charge. This approach is consistent with Section 254 of the 1996 Act.

CPI supports Commission policies that will lead to the rapid introduction of local exchange competition. A complete statement of our position on the related issues of interconnection pricing, access charges and competition is contained in the attached analysis.

Sincerely,

Ronald Binz

Ronald Binz
President

Debra Berlyn

Debra Berlyn
Executive Director

John Windhausen

John Windhausen
General Counsel

Interconnection Rates, Access Charges and Competition

prepared by the Competition Policy Institute (CPI)

The Competition Policy Institute supports the pro-competitive thrust of the Commission's Notice in its rulemaking on local competition issues. Following is a summary of our positions on the interrelated issues of interconnection pricing, access rates and the effect on competition.

- Section 251 of the 1996 Act does not permit the interexchange carriers to bypass the current access charge system However, the Act does allow new local competitors to use purchased elements to provide long distance service in conjunction with local service without paying additional access charges.

When enacting Section 251 of the Telecommunications Act of 1996, Congress was focused on enabling local exchange competition. The requirement of cost-based pricing of unbundled network elements was intended to make rapid and economically sensible entry possible by new local competitors. Although the same network functions are involved in the provision of exchange access, Congress preserved the FCC's existing access charge regime in Section 251(g). The Commission should interpret the 1996 Act in such a way that access charges are undisturbed in the case where an interexchange carrier uses facilities just to complete long distance traffic. However, new entrants, including interexchange carriers, may use unbundled elements to provide exchange access, *in connection with their provision of local exchange service.*

Section 251 does not require the immediate revision of carrier access charges. Nonetheless, pricing of access must quickly be brought into line with the cost-based approach required for pricing unbundled network elements. Modifications to access charges should also be done in conjunction with the FCC's rulemaking on universal service. But the Commission should not delay or distort its efforts to follow through on the congressional intent to enable local competition in Section 251 by taking up the access charge issue in this rulemaking

- Prices for unbundled network elements should be based on Total Service Long Run Incremental Costs plus overhead costs plus common costs.

Total Service Long Run Incremental Cost is the correct basis for inter-carrier prices in a competitive market, and should be used as the basis for pricing unbundled network elements. In addition to the strict TSLRIC costs, though, prices for network elements should include a reasonable share of joint and common costs associated with the network functions and should recover a share of overhead costs equivalent to those experienced by an efficient firm.

Due to the methodology used in computing TSLRIC costs for network *elements*, we expect that the associated joint and common costs will be relatively small. Similarly, studies suggest that the overhead costs of an efficient firm will be modest. To the extent that these prices for network elements differ from the historic accounting costs of the incumbent LECs, the prices of network elements should not include additional unrecovered historic costs. Incumbent LECs must address such excessive historic costs through product growth and by developing greater efficiencies. Finally, basing rates for network elements on TSLRIC costs means that the incumbents local exchange companies continue to have an incentive to invest in the local exchange network--this cost formulation contains a reasonable profit and a reasonable level of shared costs.

- The purchaser of unbundled loop facilities should not pay additional access charges, based on the use of the facilities

Under the 1996 Act, unbundled network elements must be provided by an incumbent LEC to enable new entrants to compete for local exchange services using these facilities. These unbundled network elements must be priced at cost. Since the new entrant will have paid the cost of the facilities, additional charges for the use of the facilities, such as access charges, are not appropriate. Additional payments required for universal service support should be paid through the universal service fund, and not as part of the price of the network element

- Local exchange carriers should continue to collect access charges when a competing LEC provides service through the resale of local exchange service.

The 1996 Act distinguishes two different ways in which a competing LEC can use the facilities of the incumbent LEC: i) purchase of network elements under §251(c); and ii) the resale of total services under §251(d). These are qualitatively different ways of entering local markets and competing with the incumbent LEC. These two methods are governed by separate provisions of the 1996 Act and each has its own statutory requirements for availability and prices.

When purchasing unbundled network elements, a competing LEC can assemble the elements to create new products, combining self-owned facilities with facilities purchased from the incumbent LEC. Although the facilities are still owned by the incumbent LEC, the new entrant will substantially determine their use and configuration. Prices of the network elements are required to cover the cost of the facilities.

The situation is different for resold services. The CLEC and the ILEC are in a retail-wholesale relationship. The new entrant is restricted to reselling the services offered by the incumbent LEC and the wholesale cost of the service is tied to the LEC's retail price, not the service's economic cost. Depending on the retail price of the service, the payment from the ILEC may or may not be equal to the service's cost.

Because of the fundamental differences between the use of unbundled network elements and resale of finished products, it is appropriate to maintain the system of access charges paid to the incumbent LEC in the case of resale at least until the access charge regime is restructured.

- The Commission should not adopt a "transition" period in which access charges are imposed on top of the price of unbundled network elements.

Some argue that the Commission should establish a "transition" period to connect its decision on interconnection pricing with its planned proceeding on access charge reform. During this transition, incumbent local exchange companies would continue to collect access charges from carriers that use unbundled network elements to complete long distance calls in conjunction with the provision of local exchange service. These access charges would be imposed even though the purchaser is paying the full cost of the unbundled network elements.

There are several reasons why the Commission should not adopt such a policy. First, the imposition of access charges (added to prices for network elements) will distort the incentives for new entrants and delay the emergence of local exchange competition. Second, the imposition of access charges in this case is inconsistent with the provisions of the 1996 Act that require unbundled network elements to be priced at cost.

Finally, as long as a Bell Operating Company collects such non-cost-based access charges, that BOC cannot meet the competitive checklist in §271 of the 1996 Act and cannot receive authority to enter the interexchange market. Section 271(c)(2)(B)(ii) of the 1996 Act requires that access to network elements be provided in accordance with the requirements of Section 252(d)(1), which requires that rates be based on cost. The addition of non-cost-based transition access charges onto cost-based interconnection charges means that a Bell Operating Company will not meet the second item of the competitive checklist

- If the Commission creates an interim charge to support universal service, it should be limited to costs directly related to universal service support.

Some commenters argue that a "transition" charge is needed to support universal service while the Commission completes its work in the universal service rulemaking. If the Commission decides to adopt such an interim charge in this docket, it should be limited to those elements of the current access charge regime that can be directly related to support for universal service, such as the Universal Service Fund, Lifeline, Link Up and Long Term Support amounts. In contrast, such charges as the Carrier Common Line Charge and the Transport Interconnection Charge (which are not directly related to universal service) should be excluded from any interim universal service charge. This approach is consistent with Section 254 of the 1996 Act.

- The Commission should not attempt to shape its policies with the goal of keeping any particular carrier "whole."

For some LECs and for some service elements, prices based on TSLRIC may be lower than historic embedded costs associated with the service. This means that a LEC may earn less by selling a network element to a competitor than now realized in the associated retail sale. Similarly, some access revenues will be lost as interexchange carriers begin to win local customers from the incumbent LECs. However, there are several mitigating effects and opportunities for the LECs to respond:

- The LECs are experiencing substantial growth in local exchange revenues and will have new revenue sources from entry into long distance and manufacturing.
- The LECs must now begin to market local service to their customers to combat the marketing efforts of the new entrants.
- Lower prices for telecommunications services will stimulate growth in revenues for all carriers, including the incumbent LECs.
- Sales of unbundled network elements will generate revenues prior to any loss of customers to competitors in the local exchange market. This will generate cash for the ILECs before competition arrives.
- The ILECs can reduce their costs. Earned rates of return remain high for the incumbent LECs. The combination of existing high earnings and opportunities for new efficiencies provides that ILECs with options to respond to competitors.
- Some of the temporarily reduced revenues will be returned to the LECs in the form of Universal Service support.

One obvious fact bears repeating. **If local exchange competition becomes a reality, the incumbent LECs are going to lose customers and market share in the local exchange, even as they move into new markets.** The Commission must not be unduly concerned that its decision on these issues will affect the *status quo*. The Telecommunications Act of 1996 redefined the telecommunications industry and completely changed the *status quo*

Consumers and carriers alike are at the gate of a new world in telecommunications. LECs will be viewed differently going forward and must begin to view themselves differently. Questions like "What is the revenue requirement and how do I collect it?" must be replaced by "What is the market price, how do I distinguish my product and lower my costs?" The Commission can assist in this transformation by ensuring that the incumbent LECs are subjected to effective local competition as quickly as possible.

- The effect of these policies will be to accelerate the development of local competition and additional long distance competition, to the benefit of consumers.

If the FCC adopts the set of policies described here, we predict rapid development of local exchange competition. It will come from new entrants that purchase network elements from ILECs and from facilities-based new entrants.

Conversely, if the Commission permits incumbent LECs to overprice unbundled network elements and requires local competitors to pay access charges on top of the cost of unbundled elements, the progress of competition will be substantially retarded.

The best outcome for consumers is for robust local exchange competition to develop quickly. If competitors are able to enter the local markets quickly, we think they will begin to compete with the incumbent LECs *at today's prices* for residential local exchange service.